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SUBJECT: DEPUTY SECRETARY'S ROUNDTABLE WITH BRAZILIAN OPINION MAKERS, THURSDAY, OCTOBER 6, 3:30 PM, AMBASSADOR'S RESIDENCE

SENSITIVE BUT UNCLASSIFIED - PROTECT ACCORDINGLY.

1.(U) Ambassador hosted a roundtable for the Deputy Secretary with a range of opinion makers from the private

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sector, academia, civil society, and government. Topics of discussion included the current political crisis in Brazil, U.S.-Brazil relations, prospects for political and economic reform, and Brazil's role in South America.

2.(U) Participants:

Carlos Pio, Political Scientist, University of Brasilia
David Fleischer, Political Analyst
Edison Garcia, CVM (Brazil's SEC equivalent)
Ellen Gracie Northfleet, Supreme Court
Emerson Kapaz, Economist
Helio Magalhaes, American Express and Sao Paulo AmCham
Paulo Octavio, Senator
Raul Velloso, Economic Consultant and Rio AmCham
Ambassador Rubens Barbosa
Sidney Levy, ABNC and Rio AmCham
Arthur Vasconcelos, Sao Paulo AmCham

Also present were Joel Brinkley of the New York Times and Carol Giacomo of Reuters. The conversation was on background.

3.(SBU) The Deputy Secretary began by posing a series of questions: What does the current turmoil mean for the economy? How does it affect prospects for political and economic reform? What are the most important issues facing Brazilian foreign policy today and in the near future, especially with respect to South America?

4.(SBU) Rubens Barbosa, former Ambassador to the U.S., expressed the view that relations between the U.S. and Brazil had been generally good for more than five years, but they reached a peak with the June 2003 state visit by President Lula to the U.S. Since then there have been some missed opportunities. Working Groups created in various areas haven't advanced. Lula wants to change the direction of Brazil's trade policy, but this bold aspiration will not be realized because it doesn't coincide with the goals of the private sector. The business community sees the government politicizing the trade agenda and focusing on areas that are not producing concrete results. Brazil is currently trying to expand its role in South America, as illustrated by its leading role in creating a Commonwealth of South American Nations and attempting to establish an Andean-Mercosul free trade area. The U.S. has devoted less attention in recent years to South America, according to Barbosa, opening a space for Brazil to act. Fortunately, Brazil's interests generally converge with those of the U.S.

5.(SBU) One of the private sector representatives took up the question of the political crisis. The failure of the political turmoil to have an adverse effect on business is striking. It demonstrates that the business climate is less dependent than it used to be on the political situation or the actions of the government. Furthermore, the business community, with its greater autonomy, can act independent of government to try to improve the business climate. There is broad consensus within the private sector on what steps need to be taken to improve business conditions and enhance opportunities for trade. There is also a growing sense that the government is unlikely to move forward on reform under current circumstances. This was evident at the recent plenary meeting in Washington of the Brazil-U.S. Business Council. Business is good, and companies are making money here. And despite the political crisis, the currency is actually strengthening and interest rates are starting to go down. This has never happened before and is a tribute to the strength of the economy.

16. (SBU) The Deputy Secretary listed a few of the recurring themes he has heard from visiting CEOs on doing

business in Brazil: It's great if you have established a niche, but when you're just starting out it's very difficult to break in. There are many regulatory obstacles, especially in the services sector. Brazil still hasn't learned to welcome foreign investors the way many other countries do.

7.(SBU) Participants agreed that Brazil needs to strengthen its commitment to market reform. Some in the business community still fear foreign competition. Brazil has historically focused on its producers, not consumers. It needs to move away from a mindset of government intervention, subsidies, and protection, and break the habits of non-market thinking. Two years ago the Federation of Industries of Sao Paulo State (FIESP) openly y broke with the government over its approach to the Free Trade Area of the Americas (FTAA). That was an important first step.

8.(SBU) Another participant raised the issue of the informal economy and gray market activity as a huge problem for legitimate business. Piracy, counterfeiting, and contraband of all sorts thrive in the informal economy, where prices are 30 to 50 percent less than in the formal economy. The business community needs political reform in Brazil in order to combat this problem. The economy may continue to grow despite the government, but won't grow 7-8 percent per year as it might with a better business climate. To fulfill Brazil's potential, the government must pass and implement tax reform, fiscal reform, pension reform, political reform, and labor reform. These measures will be very difficult for Congress to approve. Some require amending the Constitution, which requires a three-fifths majority in both houses in two separate sessions.

9.(U) The Deputy Secretary observed that Brazil is fortunate to have in place democratic institutions strong enough to pull it through the crisis, but asked how these reforms could be made to happen. The answer from the roundtable was that a new government after next year's election, with a new agenda, and a newly elected Congress, might be able to take on the challenge. But it will be necessary to connect the reforms to better growth, lower interest rates, and other concrete and tangible benefits in order to sell them. Brazil has solved its inflation problem and now has a functioning exchange rate regime. The country has made progress on the fiscal side and has demonstrated it can elect a leftist government and continue to enjoy good macroeconomic policy. But debt remains a trap because it leads to high interest rates and short maturities, leaving Brazil with a high sensitivity to internal and external shocks. Passage of the contemplated reforms would help correct this problem and overcome fear.

10.(SBU) Political analyst David Fleischer outlined all the challenges a new government will face in trying to move forward on the reforms. The Presidential system is based on coalitions, and the government will have to put together a coalition of six parties or more and try to hold it together. This could pose a serious governability problem. Others pointed out that there also needs to be a technocratic consensus around the reforms and support from the judiciary.

11.(SBU) Barbosa stressed the "sea change" that has occurred in Brazil in the past fifteen years. This is no longer a controlled economy. The government's role has been sharply reduced, in part because the government no longer has the funds to invest in the economy, leaving the way clear for the private sector. There has been substantial privatization and deregulation. Huge opportunities exist for foreign companies willing to o invest. Tariffs have been reduced significantly and exports have been stimulated. But one major remaining obstacle to trade is logistics. As of now, Brazilian products are competitive until they leave the factory door, and will be more so if the reforms are enacted, but the state of roads and ports remains a serious problem, as do the inefficiencies and bureaucracy of the government. The President is always powerful in the first months of a new administration, and if the business community can make the Congress understand what is at stake, perhaps the reforms can be enacted. Something must be done to alleviate the tax and other burdens placed on business. If the reforms can be passed and implemented, the gains in competitiveness will be enormous.

12. (SBU) The Deputy Secretary reiterated that the U.S.-Brazil bilateral relationship remains good, with lots of cooperation. No one should underestimate the importance of what Lula has done: He came from the left, followed a democratic path, eventually persevered, and is now pursuing a responsible macroeconomic policy. Brazil now needs to break through traditional barriers and become fully

integrated into the global economy, as China and India are doing. Brazil is moving, but others are moving faster. Some in Brazil see things through traditional lenses; the country and its leaders may need to develop more confidence. He expressed hope that the confidence shown by the private sector may filter through to government leaders.

13.(U) This message was cleared by the Deputy Secretary's party.

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